SPEAKING NOTE

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Speech by Martin Wheatley, Managing Director, FSA

Wheatley Review – the future of LIBOR

10 August 2012

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Introduction

Good morning and thank you all for coming today.

I've invited you here to update you on the UK's response to the Libor scandal, and to introduce my review – the Wheatley Review. I've been asked by the UK Government to look at how we can reform the system to ensure credibility and trust for people that use Libor, and the end consumers that are affected by it.

Libor is something most people hadn't heard of until a month ago, but because it sits behind so many financial transactions worldwide it is something that is fundamental to the smooth running of markets, and to confidence in the financial system.

It's because of this that we're taking an immediate, but considered approach to getting this right.

And I'm taking a particular interest in this because I'm convinced that regulation needs to start dealing with how poor conduct within

wholesale markets impacts upon the end consumer – whether it's directly through their mortgage rates or other products.

There are three things that I want to cover today:

- firstly, why this is important;
- secondly, what my review is going to look at; and
- thirdly, possible options for change.

Why Libor matters and why it needs to change

Why Libor matters

I would like to take a moment to explain the importance of Libor and what we have at stake here.

Libor – the London Inter-Bank Offered Rate – is a benchmark used to gauge the cost of unsecured borrowing in the London interbank market. And it sets the price for hundreds of trillions of dollars worth of contracts worldwide. But it doesn't just affect banks. It's also the benchmark for pricing some UK residential mortgages, more commonly commercial mortgages, and increasingly for pricing commercial loans by banks to UK businesses.

This means it has become an integral part of the modern financial system, referenced in a huge number and variety of financial contracts.

So it’s vital that people trust it, as so many things, from complex trading in the City through to a person’s mortgage and pension, depend on it. And that is why it is critical that it works well and reform is comprehensive and effective.

<u>Why it needs to change</u>

So I’ve set out why Libor is important, and it’s partly the importance of Libor that explains why what we have at the moment needs to change.

Over the years, the use of Libor as a reference rate for derivatives has overtaken what it was originally set up to do, which was to only cover lending markets.

Libor is also intended to represent unsecured interbank borrowing costs for a range of maturities, but as this type of lending has severely declined since the financial crisis, submissions are more heavily reliant on judgement.

These evolutionary factors on Libor usage, as well as the findings from the investigations into Libor manipulation, highlight that the existing structure and governance of Libor is no longer fit for purpose and reform is needed.

Beyond Libor, the future for other benchmarks is also under scrutiny.

Wheatley review

So I’ve set out why Libor is important, why its integrity is important, and why any manipulation of this system must be addressed.

Because what is clear, is that the past few months have presented a series of very significant reputational challenges for the financial services industry.

The attempted manipulation of Libor and its European equivalent Euribor have cast a shadow over the industry at large and the construction and governance of the benchmarks themselves.

We have been working very closely with other international authorities on the investigations, which we'll continue as we move forward with our reforms.

But if we set to one side the outcome of the ongoing investigations, trust in a vital part of the financial system has been lost, and timely action is needed to regain it.

Part of the UK Government's broader response has been to establish a Commission to look at the culture and professional standards in the banking system, with recommendations to be considered as part of the Banking Reform Bill next year.

And of course, the Financial Conduct Authority, which I will lead from next year, will be a new regulator focussed on tackling market abuse and protecting consumers

Our core purpose will be to make sure financial markets work well so that consumers get a fair deal.

This will extend to our approach to dealing with conduct between sophisticated market participants – where poor conduct is not only

about market abuse or fraudulent activities – but extends to a range of activities that exploit differences in expertise or market power and can all to often result in conflicts of interests.

What's clear to me is that such conduct is not a victimless act simply because it takes place between sophisticated market participants. It's clear from the reaction to the Libor scandal, that consumers think it's important.

It's within this context, that I've been asked to lead a review to assess and address the issues that LIBOR faces to ensure that it is fit for purpose.

We'll make recommendations to the Government, who will then take a decision, and implement any changes in the Financial Services Bill.

My review will look at three areas:

Firstly, **reforming the current framework for setting and governing Libor**.

As part of this, we will look at, amongst other things:

how banks submit data, and whether actual trade data can be used to set the reference rate; the governance of Libor; and whether the setting of LIBOR should be brought into statutory regulation.

We will also look at alternative rate-setting processes and the financial stability consequences of a move to a new regime and, how a transition might be appropriately managed.

Secondly, we will look at how we work out the best way to **tackle abuse**. This will consider the scope of the UK authorities' civil and criminal sanctioning powers to deal with the type of misconduct we've seen. We'll also look at whether individual persons in banks with a role in LIBOR setting should be subject to prior approval by the regulator.

And finally, we will look at other areas where price-setting mechanisms are used in financial markets and whether we need to make policy changes. We'll make provisional recommendations designed to inform the work on benchmark reform being considered at globally.

Introducing the Discussion Paper

The first step in all of this is the paper that we're publishing for consultation today.

This represents our early thinking on the issues so that we can hear back from you over the next four weeks.

I realise this is a very tight timescale, but this is an important issue that we need to get right quickly. In order to tackle something so complex it's essential that we draw on the full range of expertise and opinion from across the marketplace, including rate setters, end users, and other regulators.

We will also be seeking to engage with a wide range of international regulators such as, IOSCO and its members, key European institutions, the CFTC, the SEC and the US Treasury who are considering in tandem similar issues for other benchmarks within their markets.

Options for change

I want to set out now the possible options for reform that we're looking at and that we set out in this paper. This paper invites you to discuss it amongst your firms, members and clients, consider and respond.

At this stage, we're looking at two possible options.

These are:

- to reform Libor; or
- to use alternative to Libor for at least some of its current uses.

This Discussion Paper offers some initial analysis on the options for reform, but ultimately we are seeking your feedback, to inform our understanding.

The reform of LIBOR

If we choose the path of maintaining Libor as a reference rate, but reforming it to tackle all its current weaknesses, then there it's clear there are three key areas we must look at.

These are how Libor is compiled, the governance around that, the regulation of Libor, and the relevant sanctions regime.

So firstly, there are many potential remedies to explore on how Libor is compiled. For example:

- Seeking to minimise judgement in Libor submissions and using more hard, transaction-based data.

- Introducing a standard procedure to corroborate individual submissions.

- Delaying the daily publication of individual submissions, to mitigate manipulation whilst maintaining transparency.

- Or even, altering the calculation that is used for the final rate.

The focus of the popular debate has been around the use of actual money market transaction data as a basis for the rate.   People are right to think that such a change could help to overcome the issues of subjectivity and corroboration, and other benchmark rates are structured in this way.

But there are of course still difficulties, not least of which is the low volume of transactions in particular currencies and tenors under the current LIBOR definition of interbank lending. Then there are the governance issues that other benchmarks with this type of construction will still present.

So it may be that the use of actual transaction data needs to be coupled with a widened definition of relevant funding to include other products such as commercial paper or corporate deposits.

Improvements might also be made through a reduction of the less used maturities and currencies that are quoted. Perhaps some sort of hybrid of transaction data and a hypothetical rate might prove most effective, using judgement to fill the gaps where and when data is scarce, within a specified framework.

But this brings me back to the question of using judgement – and so some kind of trade reporting mechanism may also need to be established to supplement it.

What is clear is that these are all questions that require careful consideration.

The second key strand to LIBOR reform is **governance**.

The place we're starting from is that any new governance framework should ensure that the compilation process itself is subject to a much greater degree of independence, transparency and accountability.

Governance within contributing banks also needs to be subject to a much greater degree of internal oversight and scrutiny, following precise policies and procedures to ensure there is no repeat of past

failures, and to ensure greater independence and transparency around the LIBOR setting process.

So our discussion paper will outline options for consideration. For example, giving a commercial body responsibility for providing reference rate information to the markets, or by allocating responsibility to an industry group.

Finally, we turn to the issue of **regulation**.

The paper considers two possible options for reforms to the regulatory and criminal sanction regime to address the weaknesses in the present system;

First, bringing LIBOR-related activities into statutory regulation. And secondly, in addition to this, strengthening the powers of prosecution available to the FSA (and, in future, the FCA) for LIBOR-related offences.

If we went for the first option, we would need to consider some key questions:

- which activities relating to LIBOR ought to be regulated – is it the contribution to rates or the compilation of rates, or both?

- whether and how the Approved Persons regime ought to be updated to reflect the regulation of LIBOR-related activities, and

- whether contributing to LIBOR ought to be made subject to a form of regulatory compulsion. Clearly, the rate works best when there are many contributors but participation is currently voluntary.

In the paper we consider some of the technical elements to changes in the law, but we know we must also be mindful of the work being undertaken by the European Commission on its Market Abuse Framework.

Replacement of LIBOR with other benchmarks

So I have set out for you some of our provisional thinking on reforming LIBOR.

But whatever improvements are made to LIBOR, we will want to consider alternative benchmarks for at least some of the types of transaction that currently rely on LIBOR.

In some cases, there are existing rates that could be used more widely. In other cases, new benchmarks would be identified and developed.

But any migration to new benchmarks would require a carefully planned and managed transition, in order to limit disruption to the huge volume of outstanding contracts that reference LIBOR.

These are questions which we ask you to consider as part of your responses.

The discussion paper sets out some of the criteria which we believe such an alternative rate should fulfil, and evaluates some of the options that are currently available.

Implications of our thinking for other benchmarks

As I outlined earlier, we're also going to look beyond LIBOR, at whether similar considerations apply to other price-setting mechanisms in financial markets, and provide provisional policy recommendations in this area.

Other markets also rely crucially on benchmarks, and some may share similar weaknesses to Libor, such as being judgement-led or having similar governance structures, and may therefore benefit from closer examination.

The European Commission has already acted promptly to address market manipulation related to LIBOR, and other rates such as EURIBOR, by adopting amendments to the proposals for a Regulation

and Directive on insider dealing and market manipulation, including criminal sanctions.

This is encouraging and important to get right and will now be subject to negotiation between the Commission, Parliament and Council.

We know there’s a strong appetite for reform at a European and global level for benchmarks set and governed in their jurisdictions.

I hope that our wider findings will form a useful contribution to the efforts of the EU and global regulators as they consider these issues.

Conclusion

So I have set out for you why Libor is important, and the weaknesses in the current system that the recent findings of attempted manipulation have highlighted.

I’ve then set out what my review will look, some of the options we’re considering and how you can help develop our thinking.

It is clear that regardless of the outcome of ongoing international investigations, trust in a vital part of the financial system has been badly damaged and timely action is needed to restore it.

Today, we are taking the first step in this process by launching our discussion paper.

Any decision taken will need to be phased in so that it does not disrupt market orderliness, particularly in systemically important markets.

I encourage you to consider all of the issues I have outlined today, and give us your views.

It is only by utilising the expertise from across the financial sector and across the globe that we can effectively solve the problems before us for LIBOR, and provide a foundation for the work that will be taking place on other benchmarks around the world.

My goal is to ensure that LIBOR is reformed in a way that ensures credibility and trust – both in our financial system and for consumers that rely on us - to ensure that markets work well and consumers get a fair deal.